

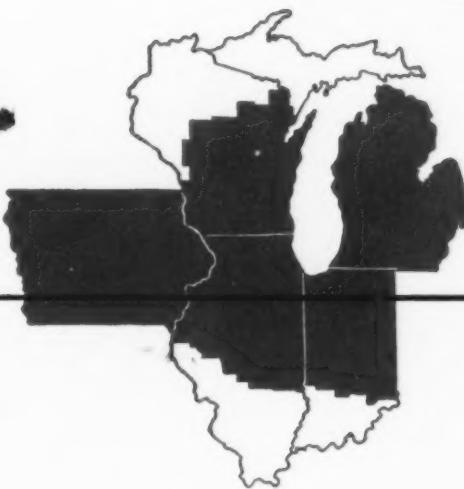
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A review by the Federal Reserve Bank of Chicago

APR 3 '57

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Business Conditions



1957 March

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THE Trend OF BUSINESS

In the past month or so business analysts have been taking a new look at the generally optimistic forecasts made earlier. Whether the reappraisals will result in shifts in business expectations and plans remains to be seen.

A number of recent developments have given grounds for the review. Possibly most important has been evidence of a decline in new orders for capital goods and concern over a continued squeeze on profit margins. These factors, no doubt, were largely responsible for a period of weakness in the stock market. Also on the bearish side have been price declines in several important commodities, continued weakness in housing starts, a lag in rail freight and truck loadings and a greater-than-seasonal shrinkage in bank loans. In addition, views expressed in influential circles on the longer-term implications of a rising trend in Federal spending seem to have made a strong impression and may have contributed to a weakening in business confidence.

Seasonal or cyclical

It will be recalled that a year ago a similar period of economic soul-searching was taking place. At that time it was widely believed that 1956 was bound to suffer by comparison with the spectacular surge in business in 1955. Sluggishness in automobile production and sales and in residential construction had already become apparent, and business inventories which had been building up rapidly were considered vulnerable to a decline. As things turned out, autos and housing remained relatively weak through the year, but business spending surged ahead. On balance 1956 proved by a considerable margin to be the nation's most prosperous year to date.

2

The list of soft spots at today's reading is longer than last year's, but not necessarily more imposing. Consumer spending and government outlays, two of the most important mainsprings of demand, continue to show buoyancy. Strength in these sectors may well prove more than a match for the mild, if more numerous, weaknesses elsewhere.

Retail sales in January totaled just under 15 billion dollars, 7.6 per cent more than in the opening month of last year. Allowing for the normal Christmas-time bulge and for differences in trading days, sales this January held to the high level set in December. Sales continued strong into February, as indicated by reports from department stores. In major District cities department store sales topped year-ago by about 10 per cent in the first half of February. Furthermore, consumers show no evidence of slowing their spending pace and, considering their current rate of saving, should be well able to step up their buying if they become so inclined.

Government purchases of goods and services are estimated to have attained a yearly rate of 82 billion dollars in the closing quarter of 1956. The year as a whole saw Federal purchases climb 2.3 per cent and state and local, 9 per cent. That the public sector will continue to exert an expansionary effect as the year proceeds seems assured, judging from the new Federal budget and from the tempo of state-local activity, particularly in the fields of highways and schools.

Leveling trend?

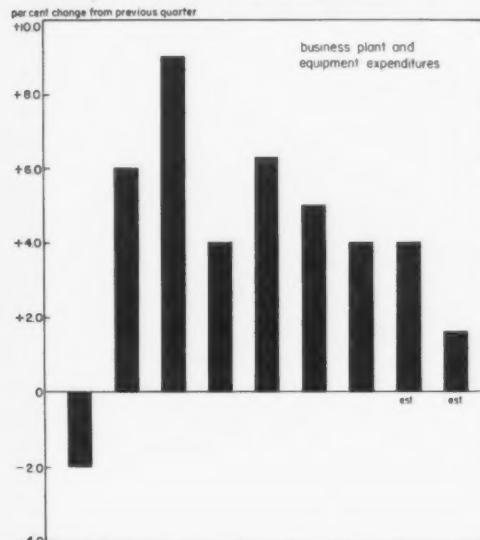
While the pace of business activity continues basically strong, with some of the most significant indicators either steady at record readings



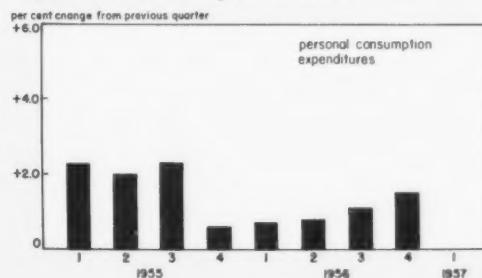
The nation's **output** showed increasing quarter-to-quarter gains in 1956 . . .



Business plant and equipment spending gains continued but at slowing pace . . .



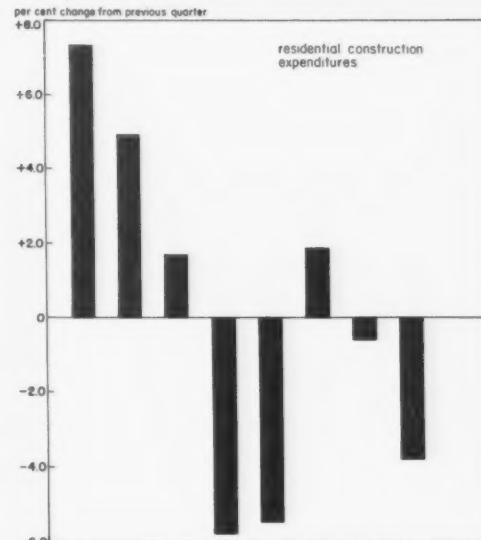
Continued expansion in **consumer spending** has been an important offset . . .



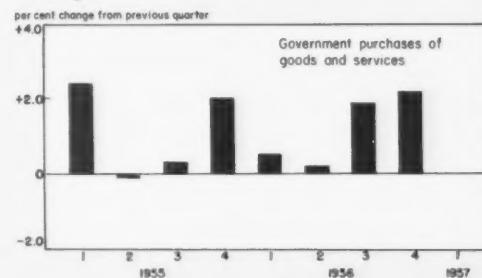
but rising **prices** were accountable for about half of the increase



and **residential construction** outlays have declined



along with climbing **Government** outlays



or else still climbing, there is evidence that the activity curve no longer is inclined upward as noticeably as it was a while back. The index of *industrial production*, for one thing, moved downward in January by 1 point from the record 147 scored the month before.

Nonfarm *employment* in the year's first month held at its earlier record level, but a reduction in the average factory work week, in part seasonal, brought weekly earnings down 2 per cent from the December peak. Total employment in nonagricultural establishments showed a further small rise in January and was about a million above the year-earlier figure even though the number of production workers in manufacturing declined somewhat. Total unemployment meantime rose seasonally to 2.9 million, about the same as a year earlier but materially below the January 1955 level.

In the Midwest, nonfarm employment has not shown the rise recorded nationally where figures for recent months exceeded year ago by about 2 per cent. In January, 14 of 24 major labor market areas in the District reported 3 per cent or more of their labor force unemployed, according to the Bureau of Employment Security. This compares with 7 centers in January 1956.

Employment stable at high level

| | January | | |
|-----------------------------------|---------|-----------------------------------|------|
| | 1957 | 1956 | 1955 |
| Employment | | (millions) | |
| Total | 62.9 | 62.9 | 60.2 |
| Nonfarm establishments | 52.1 | 51.1 | 48.8 |
| Production workers, manufacturing | 13.2 | 13.4 | 12.6 |
| Unemployment — U. S. total | 2.9 | 2.9 | 3.3 |
| Insured unemployment | | (per cent of covered employment)* | |
| U. S. | 4.4 | 4.2 | 5.5 |
| Illinois | 3.1 | 2.7 | 4.7 |
| Indiana | 4.1 | 3.3 | 4.0 |
| Iowa | 3.9 | 3.4 | 3.7 |
| Michigan | 4.3 | 3.9 | 4.0 |
| Wisconsin | 3.6 | 3.2 | 4.6 |

*Last week in January

SOURCE: U. S. Department of Commerce and Bureau of Labor Statistics.

Construction contract awards turned down in March of last year and gave ground steadily thereafter, declining in the course of the year from a 30 billion yearly rate in February to less than 20 billion in December. Reflecting the large volume of earlier contract letting, *construction outlays* have continued stable at a high level, with strength in public construction largely offsetting weakness in private expenditures.

The business inventory build-up appears to have been losing some of its steam as stock-sales ratios have risen somewhat and delivery schedules have reflected the easier supply situation in many lines. These conditions have touched off inventory liquidation in past periods, usually following evidence of a slowing of retail sales. Such evidence is not at hand currently or in prospect. A flattening in business plant and equipment outlays in coming months also is expected, to judge from results of recent surveys of business spending plans.

For the first time since 1954 *metal prices*, with the notable exception of selected steel items, have been tending downward. Steel scrap, quoted at an all-time high of \$65 per ton last November, was down to \$50 in February. Tin is off 8 per cent from its recent high.

Copper, boosted to 46 cents a pound a year ago, has come down in four steps to 32 cents. Although prices of zinc, lead and aluminum have not been reduced, these metals are said to be in ample supply at the present time.

Such softness as has so far appeared, moderate in degree and largely confined to construction and durables, can be attributed in part to the effects of credit restraint helping to bring a balance between demand and supply. The appearance of some minuses in the year-to-year comparisons in this sense means that pressure on productive capacity and on wage rates and prices no longer is as one-sided as it was a while back.

The Federal Budget— a ten-year perspective

Federal Government receipts and expenditures for the fiscal year beginning July 1 are expected to reach postwar highs for the second consecutive year. According to the forecasts in the President's 1958 Budget, revenue will be an all-time high of 86 billion dollars, 4 billion above the estimated fiscal 1957 income. On the other side of the ledger, spending, in cash terms, will be well above the Korean war high reached in the 1953 fiscal year. The Treasury's cash outlays are now more than double those of a decade ago — 36.5 billion dollars in fiscal 1948 as compared with 78.3 billion and 83.0 billion expected this year and next. The Government's operations are again producing a cash surplus, as in the early postwar period and im-

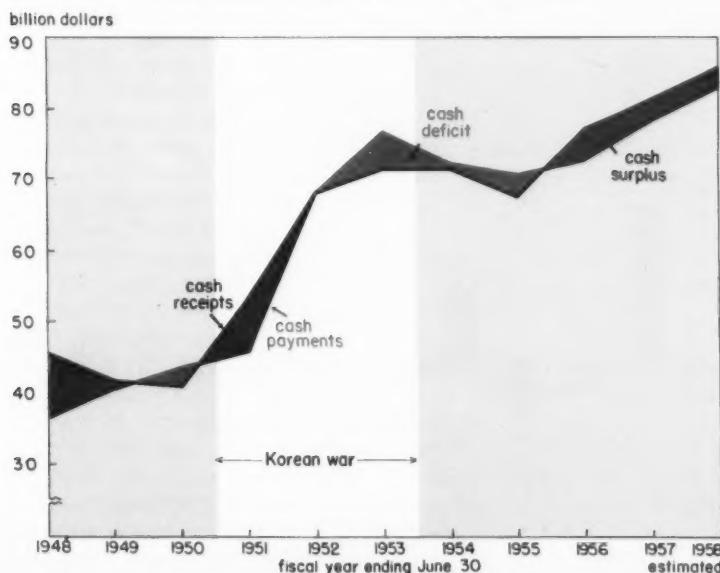
mediately after the outbreak of the Korean war, but the surplus is smaller and apparently declining.

Two-thirds of the increase in cash expenditures over the past ten years represents outlays on national security programs. Defense and defense-related outlays, which totaled only 12 billion dollars in 1948, are projected at 43 billion for the coming fiscal year. This includes 38 billion in expenditures on the armed forces, 2.3 billion for atomic developments and 2.6 billion in military aid to other nations.

Individual and corporate income tax receipts have accounted for most of the rise in Treasury income over the past ten years. By the 1958 fiscal year individuals are expected to be paying 41 billion in income taxes, almost twice the 1948 figure. The gain in such receipts reflects the rise in personal income over this period. The effective tax rates today are in most cases slightly below those prevailing in 1948.

Corporate tax collections show an even bigger increase. Over the 1948-58 period, such Government receipts should register a 120 per cent gain, in part because of the hike in rates instituted during the Korean fighting. Excise levies have also risen, but at a much slower pace. Rates in

U. S. Treasury cash receipts and expenditures



some cases are lower than in 1948, in others they are higher. Excise tax receipts for 1958 are estimated at 11 billion dollars, compared with 7½ billion ten years earlier. Increased coverage and higher rates have combined to boost employment taxes. Such payments are up sharply, from 2.4 billion in 1948 to an anticipated 8.4 billion in the coming fiscal year.

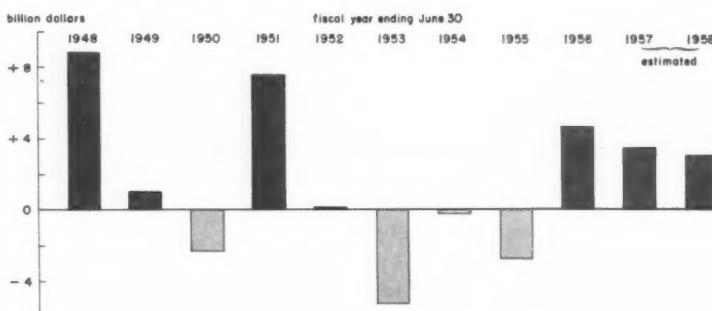
Cash vs. conventional

The Government's cash surplus or deficit reflects all transactions with the public. A substantial portion of the Treasury's receipts and expenditures flow through "trust funds" and are not reflected in the conventional Budget totals. The most important trust funds are those related to the various retirement programs, such as social security, and those dealing with unemployment insurance, veterans' life insurance, the highway aid programs and FNMA secondary market operations. The latter two are recent transfers from Budget to trust accounts.

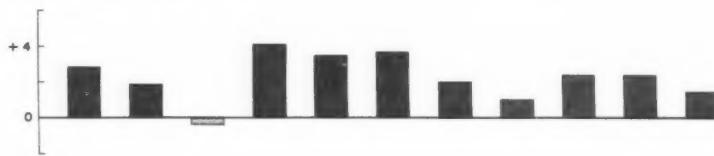
In most recent years, the trust funds have produced big surpluses;

Cash surplus to decline as Budget surplus gains

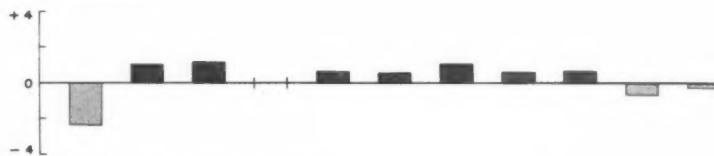
cash surplus or deficit



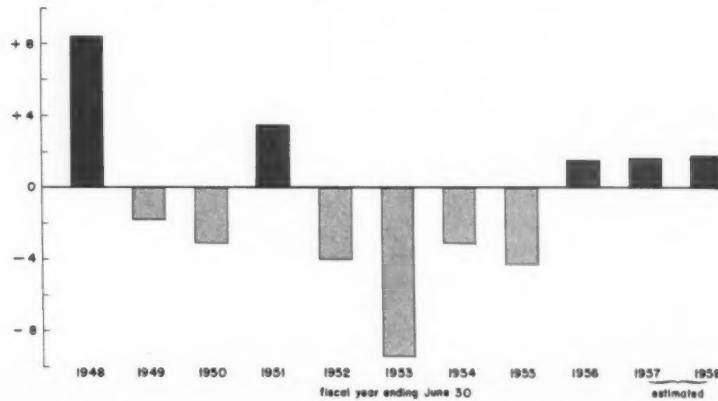
trust funds' surplus or deficit



other adjustments



conventional Budget surplus or deficit



consequently on a consolidated cash basis the Federal Government's fiscal position has been substantially better than on the more restrictive conventional Budget basis. The big surplus producer has been the social security trust fund; this, however, will soon begin to pay benefits in excess of its receipts, and hence a dwindling trust surplus can be expected.

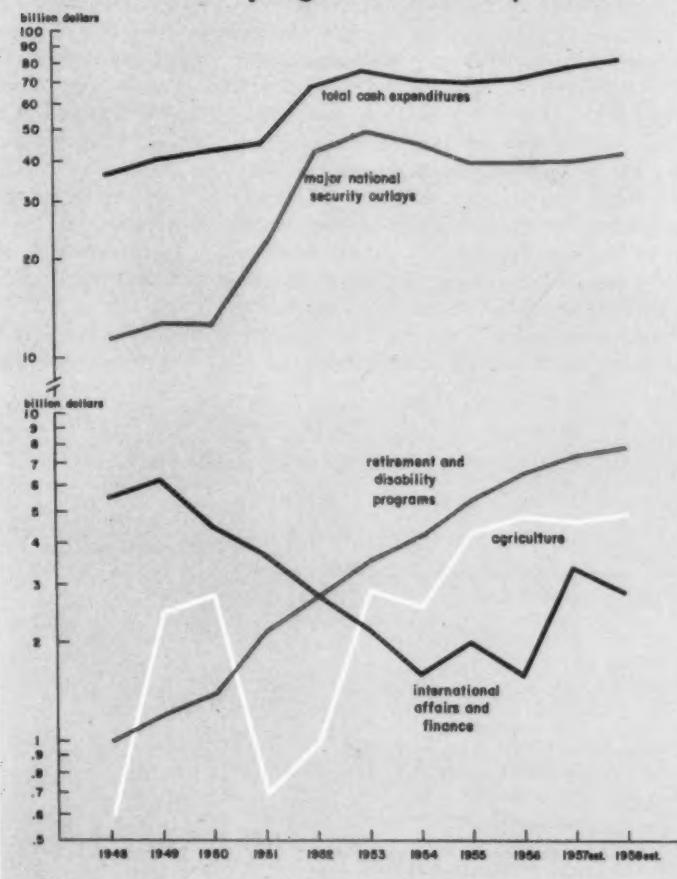
Areas of volatility

Major changes in Government spending are concentrated in a few large programs. Once again, in the new Budget, defense outlays contribute substantially to the rising expenditure totals. Yet, defense spending representing over one-half of cash expenditures should account for only a fifth of the increase in Treasury outlays from the low reached two years ago to the projected 1958 level. Agriculture

has been the most volatile area of civilian spending, since such outlays are in large part determined by the levels of farm prices and disposal programs in effect; for fiscal 1958, expenditures for agricultural programs are expected to be at all-time peaks.

The most consistent and impressive growth in Federal civil spending has been for benefits paid under the various retirement and disability programs operated by the Government — from 1 billion dollars in fiscal 1948 to 9 billion in fiscal 1958. Social security benefits alone (that

Some "civilian" programs show sharp fluctuations



is OASI) are expected to be about 14 times their 1948 total next year.

Constant share of GNP

While the conventional breakdown of Federal expenditures runs in terms of purpose or function of the outlay, they may also be classified in much the same way as is personal spending, that is, for current consumption or purchase of durable goods, or investment. For fiscal 1958, the Government's consumption expenditures — its operating expenses — are ex-

pected to top 25 billion dollars. The 10 billion dollars required to pay, feed and clothe military personnel, together with an equivalent expenditure on operation and maintenance for the armed services, constitute the bulk of such current outlays.

Just topping the spending on consumption items are expenditures on investment or long-lived goods and services. Military equipment and construction again make up the major portion of these outlays. Research and development, a part of "investment" spending, are also mainly defense-related. Most of the remaining hard goods expenditures are for housing, highway, school and hospital construction.

Character of major Federal cash expenditures, fiscal 1958 estimates

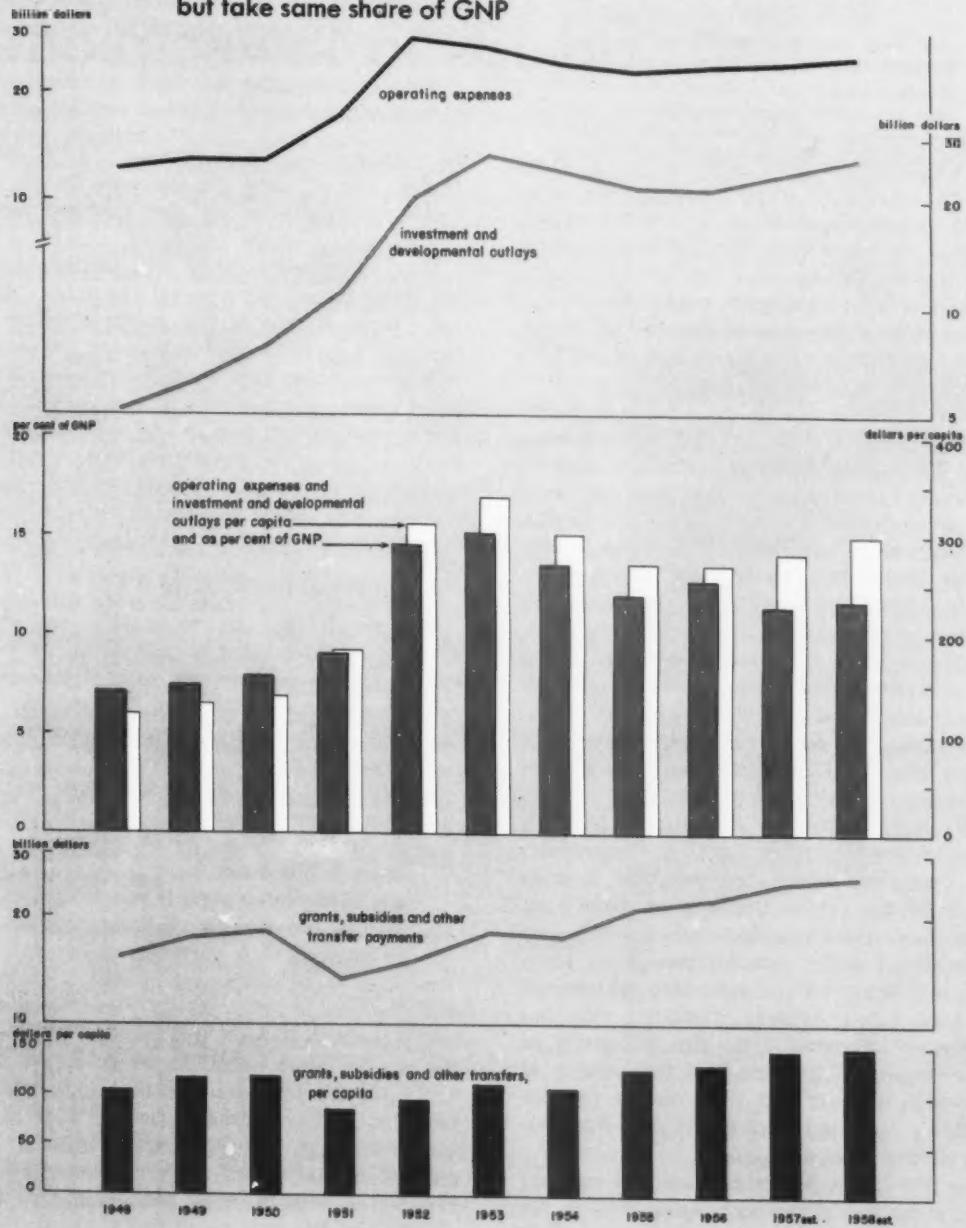
| | (billion dollars) |
|---|-------------------|
| Investment and development outlays | 26.4 |
| Federal Government plant and equipment | 26.4 |
| Defense-related plant | 4.1 |
| Defense-related equipment | 12.3 |
| Civil plant | 1.4 |
| Highways | 1.7 |
| Housing | 0.7 |
| Other loans and grants for investment and development | 2.4 |
| Research and development | 2.9 |
| Other | 0.9 |
| Operating expenses | 25.4 |
| Military personnel | 10.3 |
| Military operation and maintenance: | |
| For personal services | 3.6 |
| Other | 6.0 |
| Veterans' programs (other than transfer payments) | 1.1 |
| Civil administration, including regulatory activities | 2.1 |
| Other (largely defense-related) | 1.3 |
| Grants, subsidies, and other transfer payments | 25.8 |
| Agriculture | 3.6 |
| Veterans' benefits | 4.4 |
| International grants and loans (incl. IMF transactions) | 5.4 |
| Public assistance | 1.7 |
| Unemployment insurance | 1.5 |
| Retirement and disability insurance programs | 8.9 |
| Other | 0.3 |
| Interest on the public debt | 5.4 |

The Government's operating expenses and its outlays on investment and developmental programs have been absorbing 11 to 12 per cent of the nation's output in the past few years. While such expenditures are expected to rise 7 billion dollars over the course of fiscal 1957 and 1958, the growth in gross national product projected in the Budget will about pace the increased Governmental purchases of goods and services.

In addition, there is another category of Government spending for which there is really no counterpart in individuals' budgets. About one-third of all Government expenditures do not go directly for the purchase of materials or labor but rather take the form of grants, subsidies, loans and other transfer payments to private individuals and organizations at home and foreign governments. They include outlays for such purposes as social security benefits, unemployment compensation and soil bank payments. These payments can be spent or saved at the discretion of the recipient.

The final item of Federal cash expenditure is the 5½ billion dollars in interest on the public debt. These disbursements resemble Government consumption expenses insofar as they may be thought of as operating expenses. On the other hand, they are similar to transfer payments for they are not tied directly to the purchase of any currently produced goods and services.

**Outlays for operating expenses and investment to rise further,
but take same share of GNP**



Home building adjusts to lower plane

Residential construction activity, a pacesetter during early stages of the present business expansion, passed its crest in the second half of 1955 and since then has been tapering downward. During both the up and down phases in home building, the credit situation appears to have played an important role. In the upturn, which began in the latter half of 1953, a lessening of credit demand from other borrowers eased the availability of funds for mortgage investment. Later on, in 1954, liberalization of down payment and maturity requirements in FHA financing, which spread to terms in conventional financing as well, gave further impetus to an expansion in mortgage credit. Since mid-1955, however, the exceptionally strong demand for credit emanating from other sectors of the economy has restricted the availability of funds for mortgage lending. Rising finance charges, more stringent down payment requirements and less liberal maturity standards during this period have made it somewhat more difficult for prospective buyers to arrange financing for their home purchases.

In their *Outlook for Construction in 1957*, released last November, the U. S. Departments of Commerce and Labor projected housing starts for this year at 1 million, or about 9 per cent under the 1.1 million units in 1956. The estimate of dollar volume, though, is down less than 4 per cent, in tune with the forecast of some further advance in building costs and continued upgrading in the size and quality of new housing. This would be a continuation of trends in the past year when outlays for new building decreased more slowly than the number of new dwelling units.

In 1956, average construction cost per unit was more than 8 per cent higher than in the year before. The total value of last year's con-

tract awards, according to reports of F. W. Dodge, was off only 3½ per cent despite a drop twice as great in total new floor area contracted for.

With developed building sites all but used up, residential construction activity today calls for a larger volume of new public investment than was true in the first years after the war. New streets, sewer lines, water mains, sidewalks, street lights and schools are part of the price a growing community pays to add to its stock of dwellings. Thus, the prospective trend in total expenditure connected with additions to the nation's housing supply doubtless is stronger than spending for the housing units themselves.

The market for housing

The demand for housing in 1957 and the years immediately beyond will likely be influenced, as in the past, by such factors as:

- changes in the number of families and individuals needing housing accommodation
- the desire and ability of people to secure better housing
- changes in the tempo of geographic shifts in population
- any changes that occur in people's willingness and capacity to utilize credit in financing their purchases of houses.

Most of these factors are of such a nature that they change rather slowly — and more or less predictably — with the passage of time. Forecasting trends, therefore, would appear to be a good deal less hazardous than some other kinds of business prognostication. Unfortunately, however, the information at hand is sketchy, so the task of estimating tomorrow's physical need for housing accommodation is not an easy one.

Family formation, a neutral factor?

The marriage and departure from home of young people setting out on their own adds to the number of housing units "needed." But the dissolution of household units, by death and absorption into other units, tends to diminish the need for separate dwelling accommodations.

The number of marriages per year has held close to the 1.5 to 1.6 million range ever since it receded after a sharp upward spurt in 1946-1948. It would appear likely that the total will hold to such a level for another two or three years and then begin a slow upward climb.

People marrying today average between 20 and 24 years of age; thus they were born in the mid-Thirties. Births then were low, by today's standards, and they remained low until the eve of the war. Once the alumni of the big "birth classes" of the war and the later Forties reach marriageable age, the family formation rate should rise rapidly.

While the number of couples marrying and thus becoming prospective dwelling occupants is holding even, at about 1½ million yearly, the number of previously occupied housing units being released for their use is considerably smaller than that. The lengthening life span, for one thing, means that older people retain their accommodations longer than ever before. Moreover, there appears to be an increasing tendency for widows and widowers to continue to maintain separate quarters and for unmarried individuals to occupy dwelling units of their own.

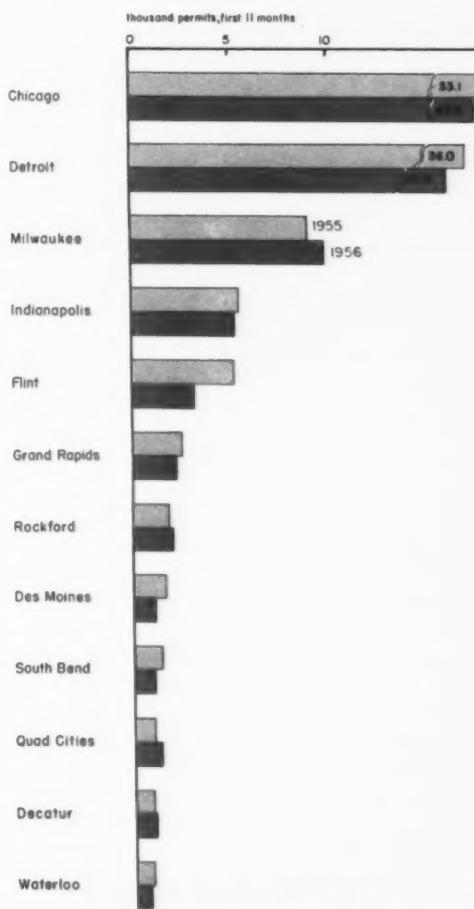
Growth in the total

Despite the relatively low marriage rate in recent years, perhaps 800-900 thousand dwellings need to be added each year simply to keep the housing stock in step with growth in the total population. Such a number of dwellings, in other words, is required to match the nation's *net* household formation.

Adding another 50 thousand to allow for new building needed to offset destruction by fire and similar causes brings the total to 850-950

Housing permits in the Midwest

The downturn in Midwest housing activity appears to have been somewhat more pronounced than the 13 per cent slide charted by the national totals. Permits issued in the 29 Seventh District metropolitan areas for private and public housing units were down 15 per cent between the first 11 months of 1955 and the same period of last year. Experience in the larger District centers varied widely, with a few up and the rest down, some by a substantial margin.



thousand units. This is considerably short of the level at which building has been sustained in the recent past. Building 850-950 thousand units each year, however, would make little, if any, provision for replacement of obsolescent and dilapidated units that are regularly withdrawn from the nation's housing "stock."

Housing in prosperity

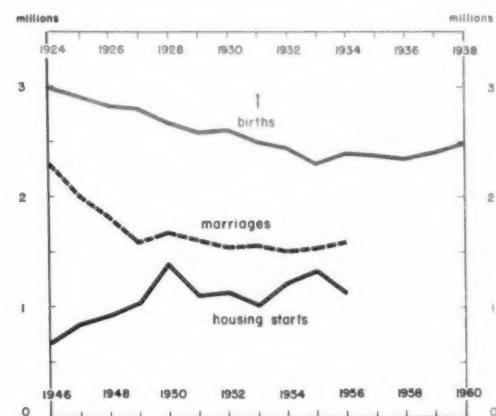
In good times, like the present, people strive to upgrade their scales of living. Often this means finding new dwelling accommodations. And as some move to new houses and modern apartments, others — in the next lower income position — move into the quarters vacated. This continuous reshuffling has the effect of removing from use some of the poorest units, and these, typically, will be demolished to make way for new construction.

From a purely physical standpoint, the buildings consigned to the wreckers might survive for many more years. But, by the standards of a prosperous community, they have lost their usefulness. In poor times, such structures doubtless would be retained for a while longer. When income is low, the burden of day-to-day living expenses and at times the threat of joblessness rule out such "luxuries" as better living quarters.

Prosperity, however, changes all this. The old house no longer will do; the old neighborhood loses its appeal as friends move on to pleasanter surroundings. Upgrading in housing, then, becomes one evidence of the nation's economic well-being.

The drive to upgrade, to discard obsolete, substandard housing, adds powerfully to demand in times when income is high and growing as well as widely diffused. The gap between the recent rate of yearly housing starts and the number of units needed to match net household formation and to offset losses by destruction suggests that real headway has been made in working down the backlog of units too old or too dilapidated for today's use. The fact, however, that 6 million units still in the nation's housing inventory were built before the turn of the century suggests that replacement

The depression's aftermath— a flattened marriage curve



demand will remain significant for some years to come.

Relocation a stimulus

Yet all this is only part of the story. Another accompaniment of economic well-being, internal migration and resettlement, is an important factor in the housing demand situation. People do not take their houses with them when they move. Thus, even if no change took place in the aggregate number of dwelling units required, the shifting around of population — and particularly the steady drift from the farms and smaller urban centers to the larger communities and to the suburbs of the biggest cities — would call for a net addition to the nation's housing inventory. The area that loses population usually is left with some housing which, while physically fit for continued use, can serve no further need where it is located.

The impact of relocation upon housing activity in recent years is suggested by the contrast between the proportion of the nation's total population residing in metropolitan communities and the proportion of housing construction accounted for by those areas. Just under 60 per cent of the nation's residents live in

the confines of what the Census Bureau terms standard metropolitan areas. In the seven years since 1949 these same areas have accounted for 72 per cent of nonfarm housing starts.

The gap between these percentages reflects the higher-than-average rate of growth of the big urban communities, growth due largely to in-migration from the central cities and from outside. In many of the smaller places and rural areas from which such movement has taken place, the stock of housing recently has been adequate for local needs. Moreover, many potentially usable if dilapidated housing units stand unoccupied in the communities from which the new converts to big city life have moved. Some of the new housing provided in metropolitan areas, therefore, duplicates another portion of the housing inventory which has become surplus.

During 1956, residential units constructed in metropolitan areas—which have accounted for most of the postwar boom in building—declined 20 per cent, while in nonmetropolitan areas there was little change. Within the metropolitan areas, however, such construction appears to have dropped far less in the suburbs than in the central cities. In the Seventh Federal Reserve District, permit volume in the peripheral or "ring" communities within the 29 metropolitan communities declined by no more than 12 per cent between the first 11 months of 1955 and the like period in 1956. But, within the central cities themselves, the decline was almost twice as great, 21 per cent.

"Undoubling" period past

Noticeably absent from the enumeration of factors bearing on the demand for housing is an item of real importance until just a few years ago, but no longer so. This is undoubling, the process of unscrambling the families that had shared living accommodations through the severe housing stringency during the war and its initial aftermath. For several years, accommodating the demand of these families for their own dwellings was one of the mainsprings of the demand for new housing. In 1947, one married couple in every 12 shared a house-

hold with others. By now, however, the proportion is only 1 in 30. Many of the families still doubled up doubtless remain so by choice, preferring this to maintenance of their own quarters.

The financing problem

Throughout the slow but persistent decline in residential construction activity, personal income has continued to gain. The housing market, however, depends upon more than the support of an adequate flow of current income. Buyers of houses and speculative developers of new housing place heavy demands upon the nation's supply of credit. Even at the reduced pace of residential construction in 1956, recordings of nonfarm mortgages of \$20,000 and less—residential mortgages, for all practical purposes—totaled 27 billion dollars, or only 5 per cent lower in dollar amount than a year earlier. Recordings in the District declined 6.2 per cent between 1955 and 1956, or by somewhat more than the total for the nation. Each of the five states registered a drop:

| | |
|-----------------|--------|
| Illinois | - 4.2% |
| Indiana | - 9.5 |
| Iowa | -10.4 |
| Michigan | - 8.1 |
| Wisconsin | - 2.0 |

The intensive over-all demand for credit during the past year has subjected the mortgage market to strain. There undoubtedly is substance, therefore, to the widespread contention that the credit situation has had something to do with the decline in housing activity. Some residential construction undertakings projected during the past season did not materialize as planned. Especially was this the case as the year drew to a close, when reports of developments that had been postponed or abandoned in an early stage were quite numerous. Yet deferral of activity was by no means confined to residential construction, as numbers of commercial, industrial, public school and state-municipal improvement plans reportedly were set aside and ostensibly for the same reason.

Particularly affected in the housing field were starts under FHA and VA financing. In

1956, FHA and VA starts combined averaged 38,500 monthly, down sharply from the 56,000 rate the year before. Housing built under those government programs typically involves low down payment - long maturity mortgages. Starts under conventional mortgage financing, on the other hand, held about even — 53,300 monthly in 1955 and 52,900 a month last year.

Since interest rates on conventional mortgages have been freer to adapt to the requirements of a tight credit market than rates on FHA-insured and VA-guaranteed mortgages, borrowers have increasingly shifted to this method of financing. The increase in December 1956 to 5 per cent in the maximum rate on FHA loans undoubtedly has narrowed the gap, lessening somewhat the relative disadvantage of this mode of financing. During 1956 as a whole, recordings of VA and FHA mortgages were down 17 per cent from the year before. The volume of conventionals recorded, however, actually showed a slight gain of something under 2 per cent.

During 1956, the economic machine for the greater part worked at peak intensity. The

credit "pinch" experienced in the course of the year reflected this and played an important role in largely preventing pressures upon limited labor and materials supplies from resulting in a precipitous price increase.

For as long as the economy's drive to spend retains its vigor, the demand for credit is likely to remain strong. And failing any marked growth in the volume of savings, credit terms and availability will likely reflect these pressures. In the circumstances, residential construction will need to justify its claim upon the available supply of credit by willingness to meet the competition for funds.

Such "real" factors, however, as the after-effects of a succession of record home-building years and the somewhat lower rate of new household formation in recent years seem to be at least partly responsible for the sag in home building during 1956. Therefore, a turnaround in the credit supply situation, presumably as a result of reduced demand from other sectors, conceivably would have a less significant impact upon the volume of activity in residential construction than it had back in 1954.

The price of business loans

One important characteristic of the booming economy of 1955 and 1956 was the rise in borrowing by consumers and businesses. Although all types of private indebtedness increased, particular importance attaches to loans to business borrowers by commercial banks. Business loans constitute one of the most volatile segments of commercial bank credit, and this expansion, unlike certain other types of private indebtedness, involves an addition to the money supply — an important object of monetary control.

From the middle of 1955 to the end of last year, loans to business by the nation's com-

mercial banks expanded almost 10 billion dollars, accounting for almost two-thirds of their total loan growth. Part of this, of course, was due to seasonal influences which normally inflate business loan totals during the second half of the year and reduce them in the first half. But much of the loan growth in the past 18 months was of a nonseasonal origin, reflecting the demand for funds for expansion by all kinds of businesses.

Under conditions of credit restraint the supply of funds could not expand sufficiently to satisfy all would-be borrowers. Money, therefore, became scarce or "tight" relative to the

demand for it and the price rose. As in the case of many commodities and services, however, the price at which money is quoted gives rise to some misinterpretation. In both money and commodity markets big customers may get "quantity discounts." For money, this is more likely to be true when overhead costs are significant and as high on small as on big loans.

At any given time there are differentials in interest rates among groups of borrowers reflecting differences in risk, repayment arrangements and other factors such as minimum balance requirements. These differences are particularly marked among business borrowers. One of the significant aspects of the tight money period is the extent to which these differentials have changed with the rising level of rates.

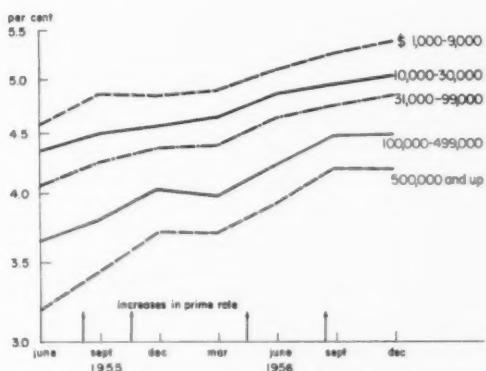
The prime rate

The key interest rate applying to business loans is the prime rate. This is the rate charged borrowers with the highest credit rating, where there is virtually no risk of loss. Although a good many loans to small firms are made at the prime rate, the majority of such loans are to large, well-established businesses. Besides being prime risks, they normally borrow in large amounts so that the per-dollar cost of servicing their loans is relatively low.

The prime rate may be looked upon as a combination of "pure interest," or payment for the use of money, plus a charge which will cover the minimum risk element and overhead costs of administration. Differentials in rates above this minimum may be regarded as compensation for higher per-dollar service costs, differences in repayment and minimum balance arrangements, and the varying degrees of risk involved in the accommodation of less credit-worthy borrowers.

Since many of the firms to which it applies obtain funds in a national market, the prime rate is standard the country over. A change in this rate is usually initiated by one of the large business lending banks and quickly gains nationwide acceptance. From 3 per cent in mid-1955, the prime rate has moved up four times in steps of one-quarter per cent to the present

The rise in average interest rates has been faster for large loans than for small



level of 4 per cent reached in October of last year. Does this mean that the cost of borrowing to all businesses has likewise increased by one-third in the interim? Some clues as to the changes in the rate pattern by size of loan and by business of borrower are provided by reports of the largest Seventh District banks on the rates charged on business loans during a 15-day period four times a year.

Large loans vs. small

Evidence from these quarterly interest rate surveys indicates that the rise in rates on smaller loans has not been as rapid as for the large loan categories. The accompanying chart shows the rate of increase from June 1955 to December 1956 in the average interest charge on loans in various size groups. Since most large loans are to large firms and most small loans are to small firms, it would thus appear that the impact of rising rates has been less severe on small businesses than on large. Some of the narrowing of this differential, however, may be explained in terms of the improvement in the quality of loans made at the higher level of rates and under conditions of less credit availability, especially in the small loan categories.

Relatively more small loans are made at rates substantially above the prime rate than

large ones, and it is in the small categories where the most upgrading apparently has been done, as shown below:

| Size of loan (thousand dollars) | September 1955 | December 1956 |
|--|-------------------|-----------------------------------|
| | Prime rate—3 1/4% | Per cent of number over 4 1/4% |
| 1 - 30 | 65 | 46 |
| 31 - 99 | 41 | 25 |
| 100 and over | 17 | 8 |

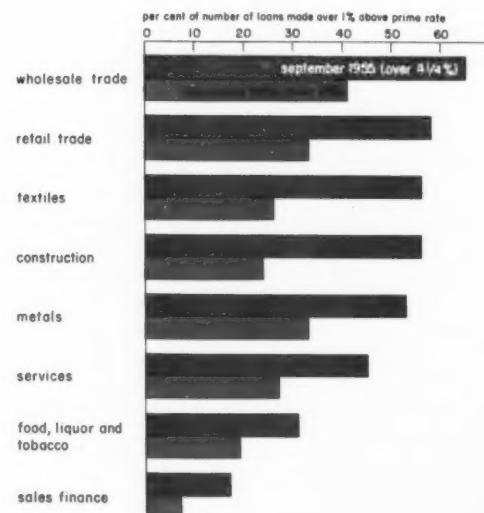
Furthermore, quarter-by-quarter analysis of the survey data indicates that most of the increase in the concentration of loans at or just above the prime rate took place in the fall of 1955. Although seasonal factors undoubtedly have some influence, the data showed substantially the same picture on a year-to-year basis.

The impact of higher rates shows up most in the large loan categories. This is due primarily to two factors: First, it is the "pure interest" cost of borrowing, reflecting the basic price for the use of money, which has risen most through the tight money period. This is a greater proportion of the charge paid by big borrowers than by small. Second, such upgrading as has occurred in small loan portfolios has reduced the margin of the average rate over the prime rate much more for small loans than for large. This indicates that the balance between the supply and demand for money has been achieved through more careful screening and emphasis on the credit-worthiness of the borrower as well as by price adjustments.

Industry differences

Since September 1955 the Seventh District

The proportion of loans made at "higher risk" rates has declined in all industries



survey banks have reported their loans classified by business of borrower. There are, of course, sizable differences in average rates paid by borrowers in the various industry groups. In the fall of 1955, for example, less than one-fifth of loans to sales finance companies by these large banks were at rates more than one percentage point above the prime rate while almost two-thirds of loans to wholesale trade firms fell in this range. Some of this variation is related to size of loans. In businesses where firms are predominantly large, such as public utilities, rates are therefore lower, while construction and service establishments, typically small firms, lie close to the top of the rate range.

As would be expected, the apparent upgrading of loans has been greatest in those industries where a relatively large number of loans were made at high rates 18 months ago. As a result, the concentration of loans at or just above the prime rate has become much more uniform among various industry groups.

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